

## INFORMATION PAPER

MCJA-OSC  
15 March 2014

SUBJECT: Federal Tax Issues Related to Military Disability Severance Pay

1. Purpose: To provide general information to Soldiers who have or will receive a one-time military disability separation payment regarding federal taxation issues related to that payment.
2. Facts: A Soldier who is found unfit by the Physical Evaluation Board (PEB) and receives a cumulative disability rating of less than 30% is separated from military service with a one-time separation payment. The PEB will make a determination as to combat relatedness of the Soldier's disability in Section V of the DA Form 199. That determination can impact whether the separation pay is excluded from gross income for federal tax purposes. See 26 U.S.C. § 104 and *St. Clair v. U.S.*, 778 F.Supp. 894 (E.D.Va. 1991).
3. Attached to this Information Paper is an Information Paper prepared by the US Army Physical Disability Agency which might be helpful to Soldiers who have received a military disability separation payment. This Information Paper is provided for general information only. Soldiers with questions specific to their tax situation should consult with a qualified tax accountant or tax attorney.
4. IRS Circular 230 Disclaimer: To ensure compliance with IRS Circular 230, any U.S. federal tax advice provided in this communication is not intended or written to be used, and it cannot be used by the recipient or any other taxpayer for the purpose of avoiding tax penalties that may be imposed on the recipient or any other taxpayer.

Approved by: Ms. Joyce A. Hamel

## INFORMATION PAPER

6 January 2014

SUBJECT: Disability Severance Pay Tax Refund/Issues

1. Purpose. To inform disabled Soldiers, separated with severance pay, of possible tax refunds.
2. Under the current department of Defense Finance and Accounting Service (DFAS) and the Internal Revenue Service (IRS) interpretations of federal law, there are tax advantages you should know about. If your disability falls under one of four categories you are eligible for these benefits. The first three are based on administrative determinations referred to as V1, V2, or V3 (10 a, b, or c on old DA Form 199), on DA Form 199, and are made by the Physical Evaluation Board (PEB). The fourth is a disability determination made by Veterans Affairs (VA). You should ask your Physical Evaluation Board Liaison Officer (PEBLO) or legal counsel if your disability was designated as either V1, V2, or V3 (10 a, b, or c) in the PEB proceedings. If such a designation was granted DFAS should not take any Federal Taxes out of your disability severance pay. If you have the tax taken out when awarded a V1, V2 or V3 (10 a, b, or c) designation DFAS has instructed that the field finance office is to contact DFAS to ensure automatic prompt refund of the withheld taxes.
3. a. If your PEBLO tells you that the PEB found you ineligible for a V1, V2, or V3 (10 a, b, or c) designation, your severance pay will be taxed INITIALLY. However, you may still qualify for a tax break if you are awarded a VA disability rating for the same condition that resulted in your medical discharge. For example, if you are found unfit by the PEB for a right knee injury, and, subsequently, the VA also rates that same right knee, you can apply for a refund of the taxes withheld. In the new IDES military disability system this usually has been determined before you are separated from the military. To secure your refund, upon receipt of your VA rating, follow the directions below.
- b. DFAS can refund all of your severance pay taxes. **However, as of the date of this paper, the IRS has not officially endorsed the DFAS position that you are eligible for a full refund. Specifically, the IRS has not officially stated how much of a refund you are eligible to receive. Consequently, in the future the IRS could claim that you underpaid your taxes for the tax year in which you received your refund from DFAS.**

(1) To secure the refund you must send copies of your separation orders, DD Form 214, DA Form 199, VA award documentation, and the attached sample cover letter #1 to DFAS by fax 317-275-0248/ ATTN: Separations Branch. To confirm that

your fax has arrived you may call 317-212-5950 (Jack Maynard); 317-212-2859 (Madie McCallum); or, 317-212-0724 (Brandon Armstrong).

(2) If you follow the above guidelines, but are not provided a refund within two (2) months of your request, contact the Separation and Reenlistment Division at any of the phone numbers listed above.

(3) The request, with all necessary documentation, must be received at DFAS by 31 December of the year in which you received your separation paycheck. If your request does not meet this deadline, DFAS cannot provide you with any refund. DFAS has indicated they will NOT provide you a corrected W-2 if you do not meet the same calendar year deadline.

(4) If you are not eligible to request a refund from DFAS because of the time limitations, and you have not filed your tax return for that tax year, you may file a tax return and include a copy of the VA award to inform the IRS that the severance pay should not be considered taxable. You should file your Federal Return with "ST CLAIR vs. THE UNITED STATES" written across the top of the tax form (NOTE: You will not be able to E-file your taxes if you use this method; you will have to file with hardcopy documents that you mail). If you have already filed your tax return for that tax year you will have to ask the IRS for a refund. **Be aware that, as of the date of this paper, the IRS does not have an official position on what portion of your severance pay is tax-free. Consequently, you may not get a full refund. Moreover, in the future the IRS could claim that you underpaid your taxes for the tax year in which you received your refund.** In an attempt to secure a refund from IRS, you must mail to the IRS copies of your Federal Individual Tax Return (or amended return 1040X, if appropriate – with the ST CLAIR vs. THE UNITED STATES written on the top) for the year in which you received your severance pay, original IRS Form W-2, and copies of your VA disability award documentation, DD Form 214, separation orders, and the enclosed sample cover letter #2. Address your request and sample cover letter to your servicing IRS location. This tax filing process to the IRS is not done very often and most tax preparers are not aware of it and are often not very well know by all IRS employees.

Enclosures  
2 Sample letters

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**SAMPLE COVER LETTER #1**

DEFENSE FINANCE AND ACCOUNTING SERVICE  
INDIANAPOLIS CENTER  
ATTN: DFAS-PJEC/IN  
8899 EAST 56<sup>TH</sup> STREET  
INDIANAPOLIS, IN 46249-0801

\_\_\_\_/\_\_\_\_/\_\_\_\_

Dear Sir/Ma'am:

I was medically discharged from the U.S. Army/ARNG, on \_\_\_\_\_. I was awarded severance pay in the amount of \_\_\_\_\_ dollars. My disability severance pay was taxed. This money was withheld for payment to the IRS.

I have now received a disability rating from the Veterans Affairs (VA) for the same disability for which the Army compensated me, and in the same calendar year that I received my severance pay. Therefore, under the provisions of 26 U.S.C. § 104(b)(2), I am eligible for DFAS refund of the taxes withheld.

Enclosed are copies of the following documents to support my request:

- VA award documentation
- Separation orders
- DA Form 199
- DD Form 214 (or 215)

Please contact me if you require additional information. My current phone # is (\_\_\_\_) \_\_\_\_-\_\_\_\_. My current address is \_\_\_\_\_.

Military pay account # (SSAN) \_\_\_\_\_.

My Current banking information is:

Financial Organization: \_\_\_\_\_.

Routing Number: \_\_\_\_\_.

Account Number: \_\_\_\_\_.

Checking ( ) or Savings ( ).

Your prompt attention to this request is appreciated.

**SAMPLE COVER LETTER #2**

INTERNAL REVENUE SERVICE CENTER

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\_\_\_\_/\_\_\_\_/\_\_\_\_

Dear Sir/Ma'am:

I was medically discharged from the U.S. Army/ARNG, on \_\_\_\_\_. I was awarded severance pay in the amount of \_\_\_\_\_ dollars. My disability severance pay was taxed. This money was withheld and paid to the IRS in tax year \_\_\_\_.

I have now received a disability rating from the Veterans Affairs (VA) for the same disability for which the Army compensated me.

Under the provisions of 26 U.S.C. § 104(a)(4), and 26 U.S.C. § 104(b)(2) (D), as interpreted by the District Court in St. Clair v. United States, disability severance payments are amounts received for personal injury(ies) and are thus excludable from taxable income. The only caveats are (1) a VA rating for the injury for which severance pay was granted and (2) a waiver of an equivalent amount of VA disability pay (See IRS "Action on Decision", #cc-1992-006, distributed 19 Dec 1991).

As indicated, I am in receipt of a VA rating for the injury for which I was granted severance pay. Therefore, I request a refund of taxes withheld in year \_\_\_\_, the year in which I received my severance pay.

Enclosed are copies of the following documents to support my request.

- Individual Federal Tax Return for the year \_\_\_\_ (the year in which I received my severance pay)
- Original IRS Form W-2
- Corrected IRS Form W-2 (If one issued)
- VA award documentation
- Separation orders
- DA Form 199
- DD Form 214

Please contact me if you require additional information. My current phone # is (\_\_\_\_) \_\_\_\_-\_\_\_\_. My current address is \_\_\_\_\_.

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(UNCLASSIFIED)

Your prompt attention to this request is appreciated.

Sincerely,